DOW THEORY LETTERS INC.

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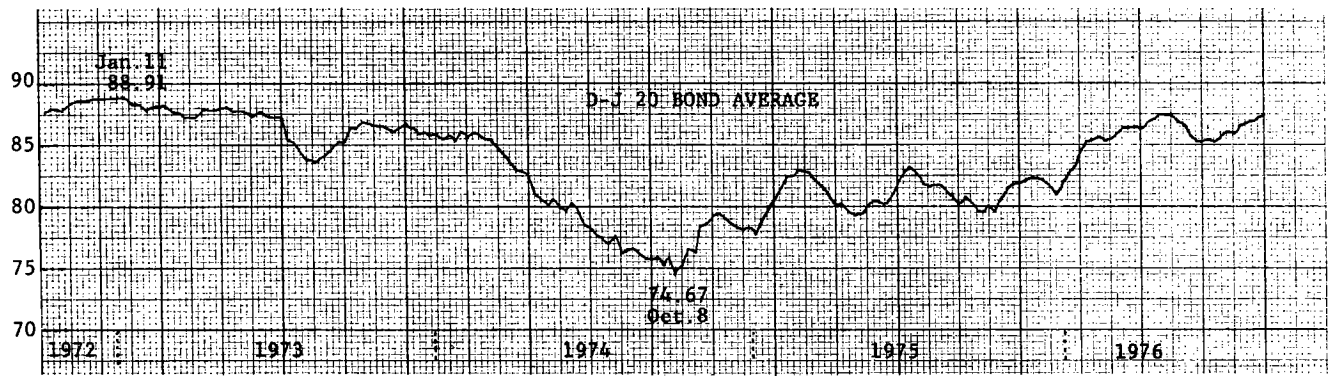
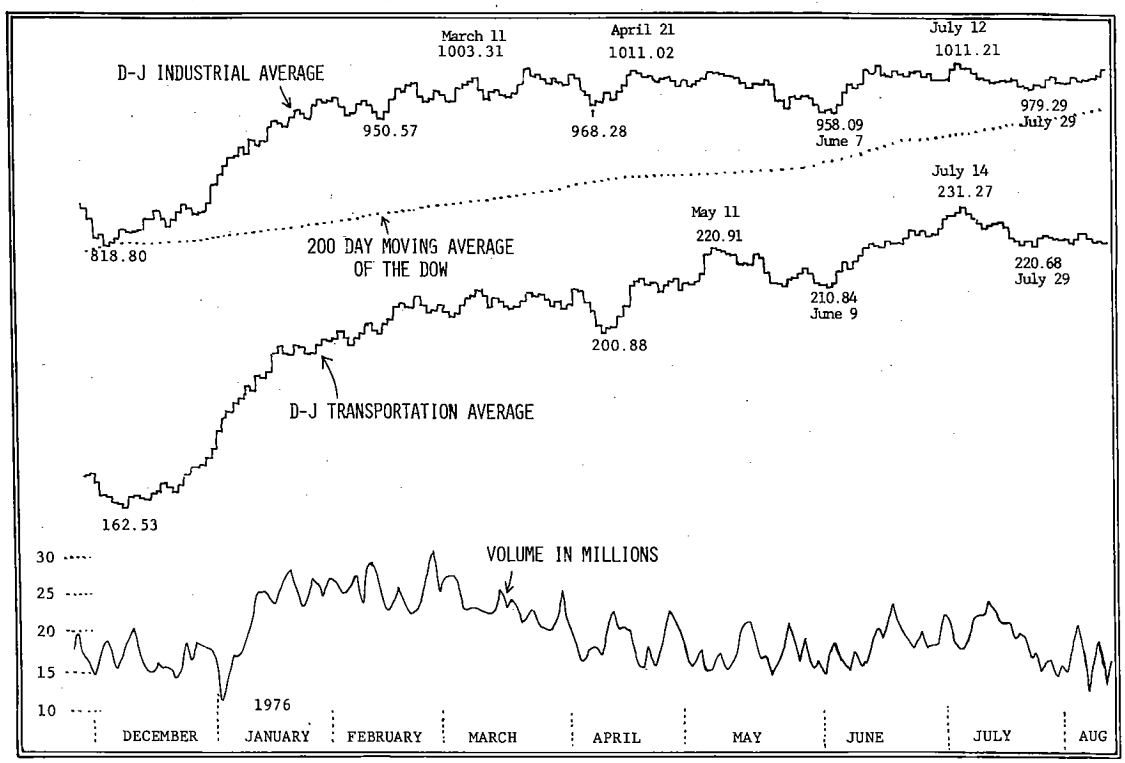


BONDS AGAIN: I am indebted to my good friend Ian McAvity (Box 182 Adelaide St. Stn., Toronto, Canada M5C 2J1) for the figures from which this chart has been drawn. Look at this chart carefully, readers, because it hasn't appeared in any other publication in the nation. It is a weekly chart of the revised D-J Bond Average (the new Average is comprised of 20 Bonds, rather than the previous 40 bonds, the Rails bonds having been removed).

Now the critical factor about this chart is that it gives us the 1973 high figure for the D-J 20 Bonds, and that high point is 88.91. This is less than one point below the current figure. IF the new D-J 20-Bond Average closes above 88.91, the Bond Average will have completed an enormous upward zig-zag and will have moved to the highest level in seven years (since 1969). In that event, the Bond Average in my opinion will have confirmed a new primary bull market for bonds, reversing a trend that has held in effect from 1946 (the high) to 1970 (the low). If we do get this kind of spectacular upside breakout in the 20-Bond Average (above 88.91), I don't see how it can be anything but constructive for the stock market. The bullishness of such an event in bonds might not rub off immediately on the stock market, but I certainly think it should exert a bullish effect in due time.

By the way, I never pan another service or another man's efforts, but I do occasionally praise another analyst. Ian McAvity's publication, Deliberations, is absolutely outstanding, in my opinion. What a man does usually reflects what he is.

THE GOOD AND THE BAD: San Diego is about as far West as you can go, and we have a lot of Country and Western radio stations out here. The other day I was a bit startled to hear a cowboy on one of our Country stations sing a song with the exotic title, "What Made Milwaukee Famous Made a Loser Out of Me." Of course, he was singing about the good and bad properties of the famous foaming brew.



Almost everything on this earth (I hear it's different in heaven) has its good side and its bad side. The good side of today's market is that the price movement is still very much intact. If you glance at this chart of the D-J Averages, you will notice that the July 29 low of 979.29 for Industrials, 220.68 for

Transports, are holding. Below the July lows are the even more important June lows of 958.09 for Industrials, 210.84 for Transports. The June lows would be the next line of defense if the July 29 lows were penetrated.

But the fact is that through all the dullness and frustration of the past few months, the June lows for the Averages have held, and more recently the higher July lows have held. That's a fact that we must all keep in mind, regardless of whether we're personally cautious, skeptical or downright bearish.

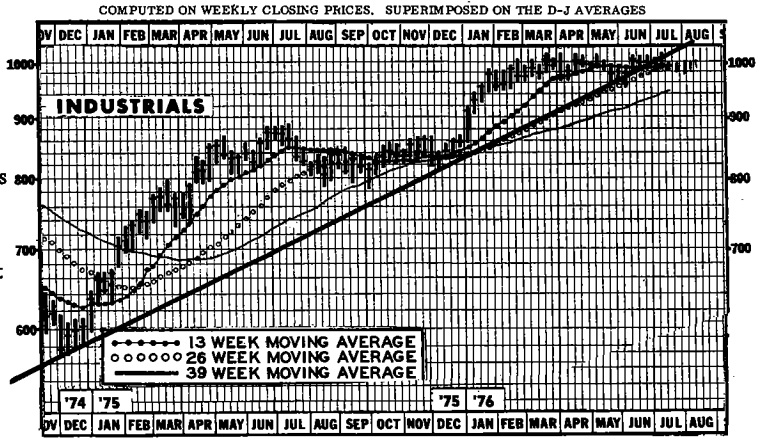
In the last Letter I showed that two of the four major Composite Averages, the NYSE Composite and the S & P 500, have cracked their major bull market (rising) trendlines. Yet it is well to remember that trendline reversals in themselves do not signal an actual price reversal. What they do tell us is that the rate of advance has changed. On the accompanying chart (courtesy Securities Research) I include the D-J Industrials and here too we note that the major trendline connecting the 1974 low and the late-1975 lows has been broken. There's no question about it, the market's rate of rise is now slowing down, and to that extent this bull market is "doing something new." But it would be a mistake to infer that the breaking of the trendline is of itself bearish. It simply means that the entire picture is less bullish than it was prior to the trendline penetration.

Another event worthy of note occurred last week. The 4-week moving average of the Dow dropped to 986, exactly one point below the 13-week MA. This was the second "sell alert" of 1976, but this time the alert came with the 13-week MA in its fourth week of decline. Personally, I don't care for it, but I hold myself back because it is not a major sell signal, just another reason for extra caution. A major sell signal is given when the 13-week MA drops below the 50-week MA (see Letter 671).

Remember, our policy all along is to give the uptrend in this bull market every benefit of the doubt. As the trendlines are broken, as the selling alerts build up, we can become more defensive, scale out weak stocks, boost our bond position, pay the cost of insurance. But no major decline in stock market history ever got going without bearish signals in the Averages, and as I have said before, the June lows and the July lows in the D-J Averages are still intact (as of this writing).

All right, a few more observations from my studies of this difficult market. I like the fact that the financial segments of this market are looking stronger, but I am growing a bit apprehensive regarding the weakening relative strength in the Transportation Average (see later section). I am also worried about the increasing number of relative strength reversals in key stocks and key groups. Last week saw the two big steel stalwarts, US and Bethlehem, break down, and that week also saw a stagnant performance in mighty GM. Downward reversals are appearing in the paper stocks (Georgia Pacific, Crown Zellerbach, Int. Paper), some of the textile stocks (Stevens, West Point Pep.), and a number of consumer-oriented issues are also either hitting new 1976 lows or turning down in relative strength (Macy's, Federated Dept. Stores, Penney's, Allied Stores, May Dept. Stores). Other big issues such as Union Carbide and Esmark have been in throes of the downside parade.

All of this is somewhat worrisome. Markets don't go up on thin air and hopes, they go up on spreading confidence. And that confidence is usually spearheaded by good leadership (from name stocks) on the upside. This market has lacked leadership for the past five months, and at this point I'm beginning to wonder where the leadership could come from. Could it be that the market (as it has so many times in the past) is mirroring the situation in the nation? Does the lack of leadership in the market reflect a lack of present and future leadership in the nation? I'll admit that the thought has occurred to me more than once.



Question: Russell, let's get it together. You have repeated ad nauseum that we should give the primary bull trend every benefit of the doubt. And then in the last few Letters you have turned neutral. Are you still giving the uptrend the benefit of the doubt—or have you changed your mind?

Answer: The Dow is now within a few percentage points of its highest level of the bull market. The A-D ratio is less than a point from its February peak. The D-J Utility and Bond Averages are strong, but the Transportation Average is almost 8 points under its 1976 high (see chart on page 1). The great majority of investment advisors are bullish, but a few "stubborn holdouts" are still bearish.

First, we're close enough now to an upside resolution so that it hardly makes sense to attempt to outguess the market. A couple of good weeks, and everything, the Transports, Industrials, A-D ratio, the various composites, the whole works could bust out on the upside. On the other hand, more declining tops on the A-D ratio, a resisting Transport Average, continued dull volume, and the market could run into increasing trouble. So why play genius, why try to jump the gun at this juncture?

Question: What happens if the A-D ratio goes to a new high but the Dow refuses to confirm by bettering 1011.21? Where are we then?

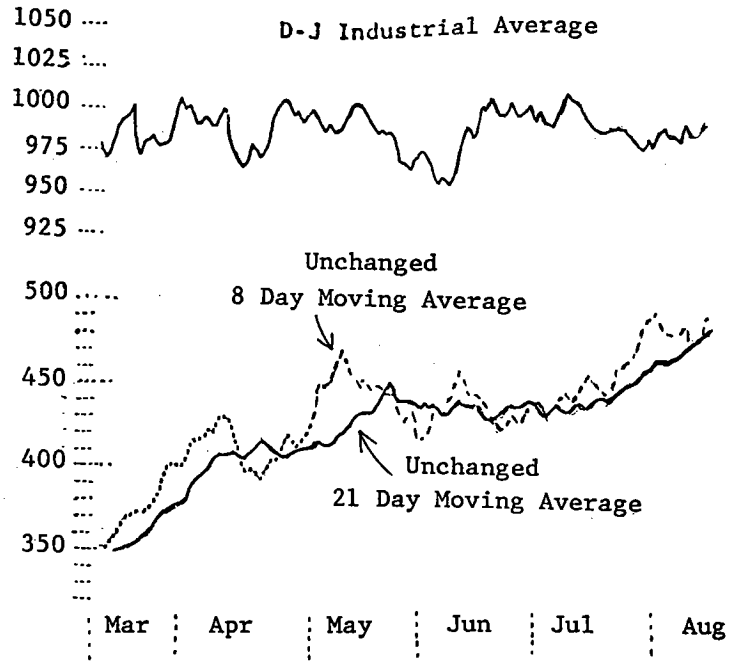
Answer: We've been waiting for five months for the A-D to confirm by bettering its February 24 high. So you're asking, what happens if it finally does confirm but the Industrials resist? My answer is that we will then be going into what I call a real "hodge-podge" market, a market where everything is going out of gear and investor frustration is king. You can make money in a hodge-podge market, but it's not easy. I would say that a hodge-podge market is the opposite of a "buying panic" market in which everything on the Board is heading up.

Thus the thought which has been increasingly on my mind is this, could the 7.2% dividend growth rate of the 1940's to 1960's be giving way to the 8% to 10% compound interest rates of the 1970's? I've been talking about bonds and high interest rates and compounding all during 1976, so it's certainly on my mind, and I'm all for it. Could I be so different from the other men who beat their brains out in the markets? I doubt it.

As an aside, it is interesting to note that the pension funds in general moved into heavy common stock positions during the 1968 to 1973 period. They did this just in time to get slaughtered by the bear market in stocks. These pension funds are still heavily in common stocks (compared to their historic stock-bond ratio). What would be so unusual about a coming big move in bonds (now that the funds are out of bonds?). The big picture from the pension fund standpoint would then be that they got caught in the bear market in stocks, and then missed the big move in bonds.

A final thought: the big variable and potential surprise in the whole equasion could be the bond market. That's why I started this Letter and the last with bond charts. If bonds break out on the upside, bond yields are going to go down (rallying bond prices provide lower bond yields). A big bull advance in bonds would narrow the stock to bond yield spread and make stocks considerably more attractive on a relative yield basis than they are now. Remember, when you talk about stock yields, you are always talking about stock yields relative to other yields. The traditional competitor to stock yields has always been bond yields.

RESISTANCE: Each day figures are released showing all NYSE issues which advanced, those that declined and those that remain unchanged. The amount of resistance to the prevailing trend can usually be gauged by the number of issues which remain unchanged each day.



The way the unchanged figures work is rather fascinating. During the early stages of a major rise, advancing issues are in the great majority, while unchanged and declining issues are in the minority. As the advance progresses, profit taking begins and therefore declining issues increase. Near and at the top (and tops are usually extended), an increasing number of issues resist and the unchanged segment therefore grows larger. In other words, a long period of high level unchanged often hints of a top.

On the other hand, during the early part of a major decline there is a period of disbelief. But as the decline gathers momentum, fear grows and the sellers begin crowding the exits. This results in a growing number of daily declines, fewer and fewer daily advances, and a shrinking list of unchanged. Finally, the selling is apt to expand into a "selling climax." In the climax, almost everything moves on the downside, and one sees a very low percentage of advancing and unchanged issues. Thus a characteristic of a selling climax bottom is a drastic decline in the unchanged issues, while the number of declining issues goes through the roof.

I am including my chart of unchanged issues, because it may be telling us something at this time. The broken line is an 8-day moving average of the number of daily unchanged issues on the NYSE, the solid line is a 21-day moving average of the same figures.

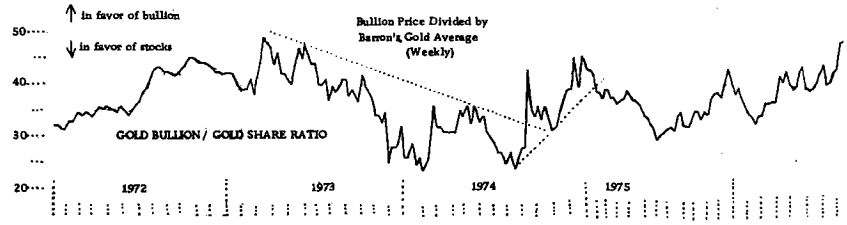
The 21-day MA of the unchanged has been rising on a trend basis throughout 1976. On August 17 the 21-day MA hit a high of 483, highest of the year. The more sensitive 8-day MA of unchanged hit a 1976 peak of 498 on August 2, and on August 17 it equalled that reading with another 498.

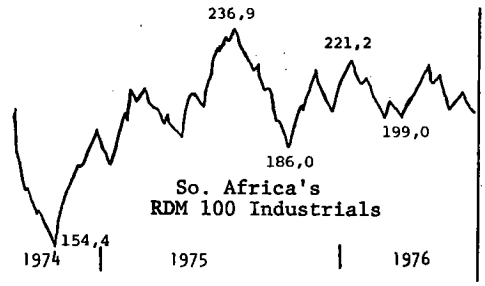
What canwe say about the chart at this time? (1) We know that the market's resistance to movement is extremely high at this time, with the unchanged issues averaging almost 500 per day! (2) We know that a continuing high level of unchanged issues is characteristic of top action (at least, judging from past experience). Therefore, the current high area of unchanged gives the appearance or a market with"the brakes on."

(3) So far, the unchanged issues have tended to remain high on all rallies and declines. This implies resistance not only on the upside but on the downside. Ultimately, the unchanged issue index will contract on a trend basis. The trend which produces that contraction will almost surely be a valid one, one that will be worth following. But as of this writing it's "no change in the direction of the unchanged index." It just keeps climbing or holding in the high area.

GOLD: Last week So. Africa imposed the "Internal Security Act" over the entire nation. This is So. Africa's answer to the growing fear of "Black Power." The Int. Sec. Act allows police to detain persons indefinitely on suspicion of subversion. Thus, So. Africa is responding to fear with fear. As law and order is jettisoned by the blacks, the laws of humanity are cast off by government. I don't care for the trend a bit, on either side.

In the meantime, black leaders talk less of violence and more about work stoppage. And this is where my previous comments





about the "poor odds" come in. There are 18 million blacks in So. Africa, 4.5 million whites. If the blacks begin mass work stoppages, the economy of SA could come to a grinding halt. The So. African Industrial Average (not golds) has been probing all of this carefully. This chart from Fred Macaskill's letter (from SA) shows what has been happening. A break by the RDM 100 below 186.0 would look ominous indeed.

As for the golds, my chart of the ratio of gold shares to gold bullion has now climbed to a level seen only three times in the last five years. It is pointing to a strong preference for bullion over gold shares. In the past, when the ratio moved near 50, bullion has always declined or the price of the shares have rallied. I am fascinated to see which of these may happen in the period ahead. BUT, if the trouble in So. Africa grows even worse, then this ratio could break out over 50 (as bullion tends to hold in the face of an even greater smash in gold shares). Any way you look at it, the crash in gold shares must rate as one of the great stock collapses in market history.

LATE THOUGHTS: As I review this Letter, it seems to me that it has too many thoughts and studies. It's too disjointed. I never like that, but I must admit that my thoughts about the current status of the market are disconnected and disjointed. When everything on Wall Street is flowing smoothly, my thoughts and writing flow smoothly too. But when I am watching a dozen studies that are bumpy and out-of-gear, I get cranky, I feel discombobulated, and my writing evidently reflects it.

I'll try to sum it up. I'm giving the bull market the benefit of every doubt, on the primary trend level and the secondary trend level. As of now the story is bullish. Yesterday the PTI and the CMAS hit new bull market highs. The A-D was very sluggish, hardly budging up, and the Transports were actually down. I spoke to an old buddy in NYC a few minutes ago, and this veteran investor asked me what I thought of the market. I said it's a bull market, but it's irritating me no end. I told him that the breadth and the Transports bothered me. "It's not that kind of a market yet," he answered, "give it time. All my stocks are in the plus column so far, and that's usually a good sign."

All right, I'll curb my natural nervousness and again suggest to myself and my readers that we give the old bull all the time it wants. We'll give the secondary trend time to straighten itself out on the upside. And if it doesn't want to, if the market insists on heading into a secondary correction, then we have the June lows and the even higher July lows as "warning signal points." We can lighten up further if those points are jointly broken (see page 1 chart). Hold off on any new purchases here (except bonds).

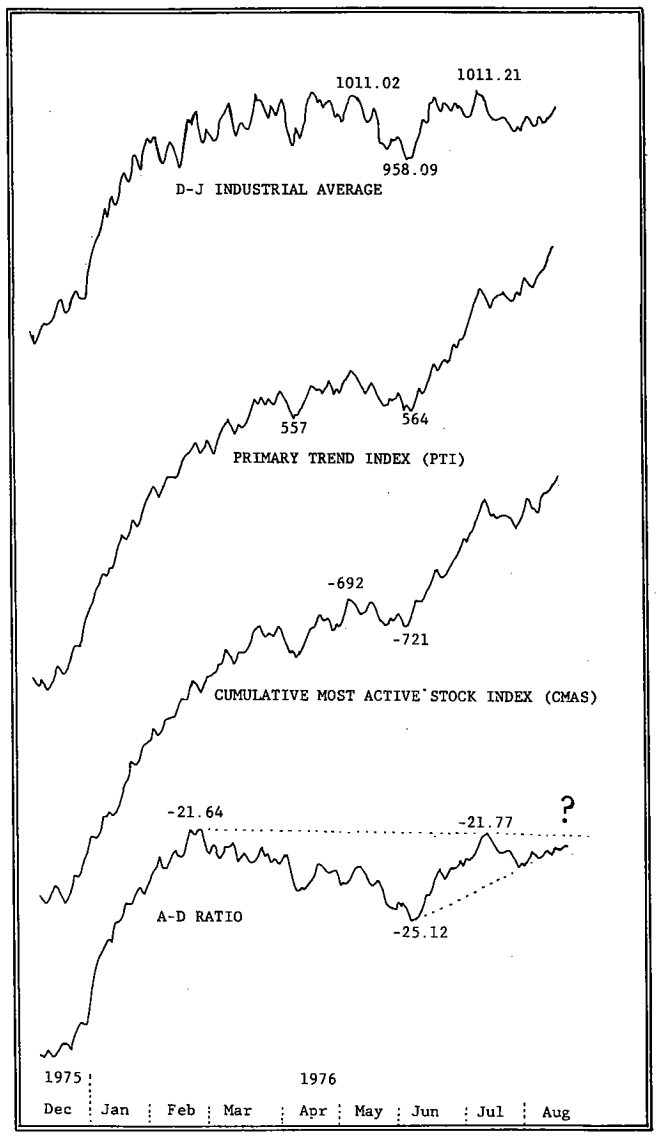
TO CANADA: I have never really loved traveling. Perhaps I developed this prejudice because my first big voyage (1942-45) was to Europe compliments of Uncle Sam. That trip was hazardous to my health. But life and growth goes on, even though I would be perfectly happy to remain hidden here in La Jolla for the next 100 years. At any rate, at the end of August I'm off to visit my old buddy, Dr. Harry Schultz. I'll be spending three or four days with the world's most traveled investment advisor (and one of the most knowledgeable.) Since I haven't seen Harry for years, I'm sure we'll have a lot to talk about. Whatever is open for publication, printable and of interest I hope to relay to my subscribers. CONSEQUENTLY, I'm taking a few days extra off between Letters. The next mailing will be on September 3rd.

NOTES: Chemical Bank is going to try to get into the stock brokerage business. Brokerage commissions are being shaved to the bone by a good many specialty brokerage houses, and I receive their literature via the mails. The banks are all watching, and if Chemical does it, there will be a parade of banks right behind. The banks don't need the brokerage business, they just want the diversification and the action and maybe the loss-leader aspect and the glory ("We're in everything, buddy, just everything."). Great, but it means pressure on brokerage house volume and profits and therefore liquidity. Many brokerage houses make markets in individual stocks (particularly over-the-counter stocks). If the brokerage business becomes progressively unprofitable, then who in the devil is going to make the markets in hundreds of stocks? Not the banks! I don't like the trend, and I think it militates towards illiquidity, illiquidity and more illiquidity for Wall Street. In the 1973-74 collapse, there was darn little market for probably the majority of O-T-C stocks. When we get our next bear market, there may not be an O-T-C market at all. Now that's a thought, isn't it.

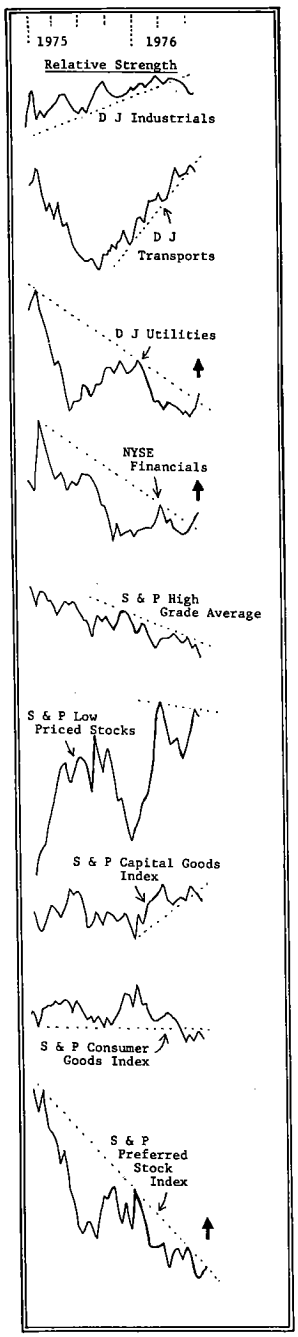
The Republican platform has taken the anti-abortion stand. They evidently haven't heard that women vote now, and the women's vote is BIG! What we need is a party with a liberal (enlightened) social outlook and a conservative economic policy. Why must we always get dinosaurs with Victorian social views and fuzzy economic views.

When I was a college student I took a course entitled "Philosophy of Democracy." One of the tenets of democracy, I was told, was that it gives the people the right to make their own mistakes. Fine and fair, I tell myself, but can Democracy survive too many mistakes? I suppose we'll find out.

One of the frustrating things about a series of non-confirmations in a market that has a slight upside bias (and that about describes this one) is that everybody thinks everyone else is making money. Therefore, I would say that for the sake of your ego and sanity, the best thing to do if the A-D goes to new highs without confirmation from the Averages is to sit tight, hold what we have and retain our cautious but hopeful stance.



PUZZLE: The divergent movements which I discussed in detail in recent Letters continue. For instance, on the composite chart of the Dow and the three indices, note that the Primary Trend Index (PTI) and the Cumulative Most-Active Stock Index (CMAS) hit new bull market highs as recently as August 16. That's impressive. Ordinarily, I would think that new highs in these two indices would produce enough technical power to push the Advance-Decline ratio up and above its February 24 peak. But so far, this simply has not occurred. Thus, the long lag non-confirmation in the A-D continues. The fact is that it has been almost six months since the A-D recorded its bull market peak. Historically (as I have stated many times), such long lag non-confirmations are not good omens for the market.



To further underscore the divergent characteristics of this market, on August 16 the S&P Utility Average hit a new 1976 high, and on the same day the NYSE Financial Index recorded a new 1976 high. On the same day the D-J Transportation Average (see page 1 chart) sank to within a point of its July 29 low, and the S&P Rail Average hit its lowest point in months.

I would say that the most persistent characteristics of this market at present are the powerful trends in the financial and interest-oriented stocks and the weak trend in the Transports and particularly the Rail segment of the Transportation Average. Ultimately, this market is going to move in harmony. But as of this writing, too many important segments of Wall Street are taking separate paths. I have always found "split markets" difficult ones to make money in, and that is one reason I have put so much emphasis on bonds over the past few months.

DEFENSIVE: The market always contains the real story of what is going on. In analysis, the fault seldom lies with the market or the charts, it lies with us (the analysts). One of the methods I use in my attempt to dig out the market's message has to do with the relative strength of various stock groups. These groups are compared on the 1st and the 15th of each month with the general market as measured by the NYSE Composite Index.

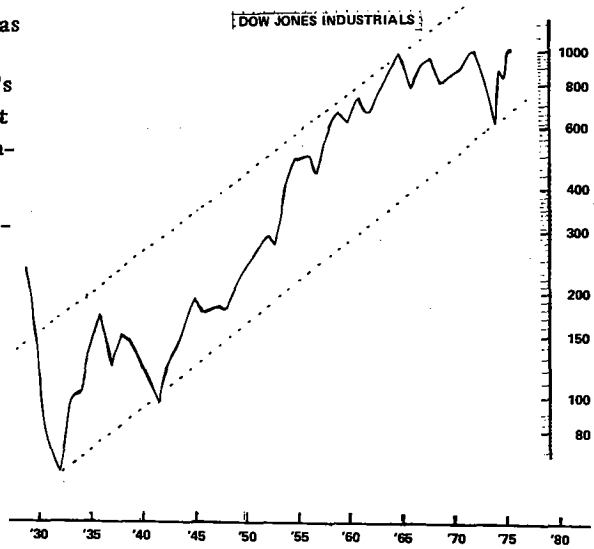
At this juncture, I feel that the group relative strength charts are telling us an interesting and informative story. I include a RS chart for the following groups: D-J Industrials, Transports, Utilities, the S&P High-Grade Stock Group, S&P Low-Priced Stock Group, S&P Capital Goods and S&P Consumer Goods Group, and finally the NYSE Financial Group.

What we see here is significant. The NYSE Financial Group (containing all the money-oriented issues such as banks, insurance, savings and loans, small loans) and the Utility Average are showing rising RS. The S&P Preferred Stock Index, which has been declining in RS for over a year, is also breaking out to the upside. All the other groups are showing neutral to declining RS.

What can we infer from this extraordinary picture? My thinking is that the market is telling us that interest rates are coming down, which is helpful for money-oriented stocks. The market is telling us that liquidity is building up, and it is telling us that the entire financial spectrum of the nation is getting back on its feet.

But these RS charts would also seem to be telling us that the economic recovery is losing some of its momentum. Capital goods, consumer goods, industrial and transportation stocks in general, these are not doing particularly well in the current market. Nevertheless, the picture is long-term positive because what is good for the nation's financial stocks is also good for the nation and its industry. For the near-term, the picture is neutral to negative in that the majority of stocks representing American industry and transportation are sagging in relative strength. For instance, with both the Capital Goods and Consumer Goods Groups sliding in relative strength, we can say that the market does not see an economic boom ahead—and I never argue with the market.

STOCKS-BONDS-YIELDS: For many decades, in fact since 1932, the US has been in a "growth economy." The accompanying long-term chart traces the Dow Industrials (ratio scale) from 1932 to present. Note that from 1932's low of 41.22, the Dow climbed to a 1966 bull market high of 995.15. That 34 year rise represented an average advance of 28 points per year. Certainly, we can call the entire 1932-1966 era one of almost steady growth.



That was the period in which much of today's investment philosophy originated, developed, and matured. And that philosophy could be expressed very simply, "Put your money and faith in good common stocks, sit back, and watch your assets grow." And it worked! Mutual funds proliferated, the public prospered, the institutions grew fat, and everyone had a good time.

The fact was that up to the mid-1960's, common stocks were following the historic growth pattern of about 3.7% appreciation per year plus another 3.5% from dividends. So it was 7.2% compounded, and who could ask for anything more?

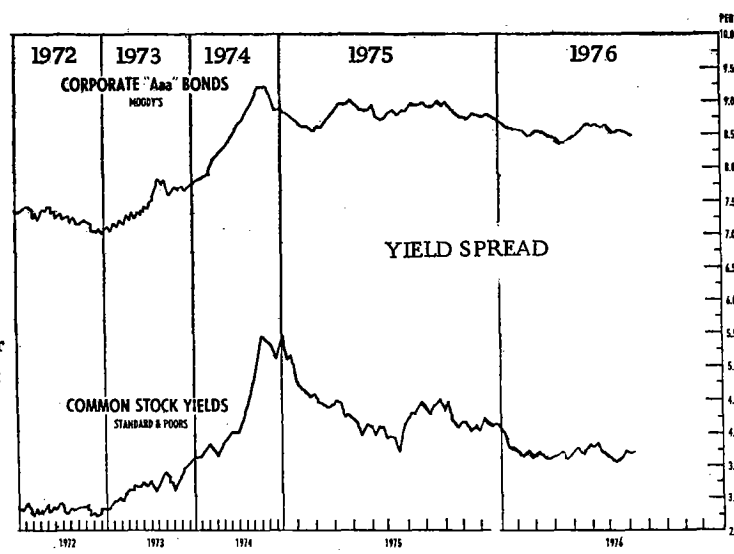
Then came 1966, the bull market top, and a trailing off of the growth rate. When 1973-74 arrived, the slide turned into a route. In the space of two years the Dow cut itself almost in half and many issues utterly collapsed. Individuals were wiped out, mutual funds saw their values fade, and many institutions lost up to half of their assets. The old growth pattern of the 1940's, 50's and 60's was knocked into a cocked hat. Sitting back and growing rich wasn't working any more. It had not worked since 1966.

Following the 1974 December bottom, the market (which had taken stocks far below known values) recovered strongly. No one, including this writer, knew whether the new bull market was fated to be simply a "rebound-recovery" affair (such as 1932-37) or another super bull market (such as 1949-66) based on a new era of growth and prosperity.

As I see it now, this is the crucial question, and it is becoming increasingly clear that the market is holding its verdict in abeyance. So far, we have had a major advance from the December, 1974 low to the February, 1976 high, and then—stall. Why, what's the real reason behind the stall?

Examine this yield chart from the Money Manager. Since 1968 we have had a fat yield apread of 4% in favor of bonds over stocks, and during 1975 and to the present this yield spread has increased to around 4.8% in favor of bonds over stocks. All of which is fine and justifiable in a growth economy. And therein lies the biggest question of all—are we still in a growth economy? Or has the towering debt structure in the US, the incursions of Government, the maturing of the nation, finally provided us with a "no growth" outlook, a hold proposition. In other words, are we now looking at an economy and a stock market that have risen from the shambles of 1973-74 in a recovery that lately has been running out of steam?

Because if we now have a no-growth economy, then the old 7.2% growth concept for common stocks isn't going to hold up. It's not going to produce a 1949-66 type bull market. And stocks are going to face tough going in the face of today's very competitive 8% to 10% bond yields.



So that's the value and yield picture as I see it today. The stock market is searching and probing the future, trying to figure out just what kind of an economy we are heading into. And the value-oriented investor is moving increasingly into bonds, big-yielding money instruments and various notes and bills.

Perhaps the great unconscious of the market is thinking something like this, "I don't see any massive growth coming up for 1977 or 1978. Sure the economy may be holding up well, but as for a boom, I just can't see it. So why should I sit here sweating out a full portfolio of common stocks which are on a low yield basis. I'll pick my spots carefully in the stock market, but it's the money market that turns me on."